

The Yale Law Journal

Volume 87, Number 6, May 1978

The Deductibility of Questionable Foreign Payments

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United States businesses have made a wide variety of questionable foreign payments.¹ The Foreign Corrupt Practices Act of 1977² makes certain bribery of foreign officials a criminal offense, but many questionable payments are not covered by the new statute³ and thus are not

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1. "Questionable foreign payments" are payments in connection with foreign transactions that may have been made to an official, employee, agency, or instrumentality of a foreign government and thus may be nondeductible under § 162(c) of the Internal Revenue Code.

For recent discussions of the nature and extent of questionable foreign payments, see N. JACOBY, P. NEHEMKIS & R. EELLS, *BRIBERY AND EXTORTION IN WORLD BUSINESS* (1977); 2 G. MYRDAL, *ASIAN DRAMA* 937-58 (1968); SEC Report on Questionable and Illegal Corporate Payments and Practices, CCH FEDERAL SECURITIES LAW REPORTS No. 642, pt. II (May 19, 1976) [hereinafter cited as SEC Report]; *Hearings on Political Contributions to Foreign Governments Before the Subcomm. on Multinational Corporations of the Senate Comm. on Foreign Relations*, 94th Cong., 1st Sess. (1975); *The Activities of American Multinational Corporations Abroad: Hearings Before the Subcomm. on International Economic Policy of the House Comm. on International Relations*, 9th Cong., 1st Sess. (1975).

2. Pub. L. No. 95-213, 91 Stat. 1494. For discussions of criminal sanctions for questionable foreign payments, see N. JACOBY, P. NEHEMKIS & R. EELLS, *supra* note 1, at 215-20; Note, *Prohibiting Foreign Bribes: Criminal Sanctions for Corporate Payments Abroad*, 10 CORNELL INT'L L.J. 231 (1977).

The United States has also considered controlling payments to foreign officials by international agreements. See, e.g., N. JACOBY, P. NEHEMKIS & R. EELLS, *supra* note 1, at 217 ("mutual cooperation pact" between Department of Justice and 10 nations for exchange of information on questionable payments by United States companies); 74 DEP'T STATE BULL. 121-23 (1976).

3. The Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, 91 Stat. 1494, applies only to bribery that involves use of the mails or other means or instrumentalities of interstate commerce. *Id.* §§ 103(a), 104(a), 91 Stat. 1495, 1496 (to be codified at 15 U.S.C. §§ 78dd-1, 78ff). (Note, however, that the use of the mails or other means of interstate commerce need only be *in furtherance of* otherwise prohibited acts. H. CONF. REP. NO. 831, 95th Cong., 1st Sess. 12 (1977) [hereinafter cited as H. CONF. REP. NO. 95-831].) Certain bribes, especially those in which the decisionmaking occurs entirely outside the United States, can be engineered to avoid the use of interstate commerce. In addition, the Act

directly proscribed by United States law.⁴ Whether or not questionable payments are illegal, however, they are subject to scrutiny under the

does not apply to payments made by foreign subsidiaries of United States corporations, though any person or entity covered by the Act who engaged in prohibited bribery indirectly via any other person or entity would be liable under the Act. *Id.* at 14. Many questionable payments are made by foreign subsidiaries.

Further, the Act contains three conditions that remove payments otherwise considered bribes from the scope of the Act. First, the Act does not apply to payments made to a foreign official (*i.e.*, "any officer or employee of a foreign government or any department, agency, or instrumentality thereof, or any person acting in an official capacity for or on behalf of such government or department, agency, or instrumentality," Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, §§ 103(a), 104(d), 91 Stat. 1496, 1498 (to be codified at 15 U.S.C. §§ 78dd-1, 78dd-2)) "whose duties are essentially ministerial or clerical." *Id.* The House Report (the language was not in the Senate bill) ties this exception to the requirement of a "corrupt" purpose and indicates that the exception is intended to allow "facilitating" or "grease" payments to be made without fear of criminal liability, H.R. REP. No. 640, 95th Cong., 1st Sess. 8 (1977) [hereinafter cited as H.R. REP. No. 95-640]; see 123 CONG. REC. H11,933 (daily ed. Nov. 1, 1977) (Rep. Eckhardt). But the language is much broader than that and arguably includes, for example, bribes to customs officials to obtain lower-than-normal duties (which occur frequently and which can involve significant payments to officials and savings to importers or exporters) and bribes to license-granting authorities to obtain import or export licenses or industrial property protection that is not allowed by law (which also occur with some regularity). (The terms "facilitating" and "grease" payments are not defined in the Act.)

Second, the Act requires "corrupt" intent. Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213 §§ 103(a), 104(a), 91 Stat. 1495, 1496 (to be codified at 15 U.S.C. §§ 78dd-1, 78dd-2); 123 CONG. REC. H11,933 (daily ed. Nov. 1, 1977) (Rep. Eckhardt); S. REP. No. 114, 95th Cong., 1st Sess. 10 (1977) [hereinafter cited as S. REP. No. 95-114]. The Senate Report states that corrupt intent connotes "an evil motive or purpose, an intent to wrongfully influence the recipient," *id.*, and that "true extortion situations" (such as paying "an official to keep an oil rig from being dynamited") would not be covered because of the lack of "the requisite corrupt purpose." *Id.* at 11. The House Report is less explicit, although it does refer to the domestic bribery statute, 18 U.S.C. § 201(b) (1970), H.R. REP. No. 95-640, *supra* at 8, under which extortion is a complete defense if it is based on a threat of serious bodily harm, or evidence of a lack of the requisite corrupt intent if it is based on a threat of only economic harm. *United States v. Barash*, 365 F.2d 395, 401-02 (2d Cir. 1966); see *United States v. Kahn*, 472 F.2d 272, 278 (2d Cir. 1973). The Minority Views attached to the House Report state: "It is our understanding that the bill is not intended to reach . . . payments made under duress to protect a business investment." H.R. REP. No. 95-640, *supra* at 19 n.1. The House Conference Report is silent on the meaning of "corrupt," see H. CONF. REP. No. 95-831, *supra*. Thus the exact scope of this term is uncertain. There is a strong argument, however, that at least extortion payments fitting the oil rig example in the Senate Report will be outside the Act. Depending on whether that example is interpreted to include a threat of damage to physical property or of more general potential economic loss, a great many questionable foreign payments could be excluded from the Act because of this requirement.

Third, the Act covers bribes to a foreign official made only to "assist . . . in obtaining or retaining business for or with, or directing business to, any person." Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, §§ 103(a), 104(a), 91 Stat. 1495-97 (to be codified at 15 U.S.C. §§ 78dd-1, 78dd-2); see H. CONF. REP. No. 95-831, *supra* at 11-12. The Senate (the House bill did not have this language, *id.* at 12) indicated that this was meant to exclude "grease" payments, S. REP. No. 95-114, *supra* at 10, but does not limit its effect to excluding such payments. Since clearly reprehensible bribes (*e.g.*, to obtain a favorable tax ruling) do not seem to fall within these categories, a significant number of questionable foreign payments may be outside the Act because of this language.

4. The antitrust laws probably do not apply to questionable foreign payments. See generally McManis, *Questionable Corporate Payments Abroad: An Antitrust Approach*, 86 YALE L.J. 215 (1976).

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accounting and disclosure requirements of the securities laws⁵ and certain other statutes⁶ and under the provisions of the Internal Revenue Code for deducting business expenses,⁷ determining the earnings and profits of foreign corporations,⁸ and computing income of United States shareholders from controlled foreign corporations⁹ and Domestic International Sales Corporations.¹⁰

The most important of these tax provisions is section 162(c), which denies deductibility as a business expense¹¹ for a payment made to a foreign official if "the payment would be unlawful under the laws of the United States if such laws were applicable to such payment and to such official or employee."¹² This article analyzes the application of

5. See Lowenfels, *Questionable Corporate Payments and the Federal Securities Laws*, 51 N.Y.U.L. REV. 1 (1976); Comment, *Payments to Foreign Officials by Multinational Corporations: Bribery or Business Expense and the Effects of United States Policy*, 6 CAL. W. INT'L L.J. 360 (1976); Note, *Disclosure of Payments to Foreign Government Officials Under the Securities Acts*, 89 HARV. L. REV. 1848 (1976). The Foreign Corrupt Practices Act of 1977 amends § 13(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78q(b) (1970), to require certain accounting practices designed to prevent the use of off-book "slush funds" and the concealed payment of bribes. Pub. L. No. 95-213, § 102, 91 Stat. 1494 (to be codified at 15 U.S.C. § 78m).

6. The Foreign Assistance Act requires firms conducting business under its auspices to report all commissions paid in connection with such business to the Agency for International Development (AID). 29 C.F.R. § 201(k) (1977). Concealing an improper payment on an AID form violates 18 U.S.C. § 1001 (1970), which makes it unlawful to conceal information on any matter within the jurisdiction of any United States department or agency. *United States v. Olin Mathieson Chem. Corp.*, 368 F.2d 525 (2d Cir. 1966). Similarly, firms financing purchases through the Export-Import Bank must report to that bank all commissions included in the contract price. 12 C.F.R. § 401.3(c) (1977). Finally, the International Security Assistance and Arms Export Control Act, which governs all foreign sales of United States military goods, authorizes the Secretary of State to require that fees, political contributions, and gifts made in connection with arms sales be reported to various governmental bodies. 22 U.S.C.A. § 2779(a) (West Supp. 1977).

7. I.R.C. §§ 162(a), (c).

8. I.R.C. § 964(a).

9. I.R.C. § 952(a).

10. I.R.C. § 995(b)(1)(D).

11. I.R.C. § 162(a) allows the deduction of "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."

12. I.R.C. § 162(c) provides:

(1) *Illegal payments to government officials or employees.*—No deduction shall be allowed under subsection (a) for any payment made, directly or indirectly, to an official or employee of any government, or of any agency or instrumentality of any government, if the payment constitutes an illegal bribe or kickback or, if the payment is to an official or employee of a foreign government, the payment would be unlawful under the laws of the United States if such laws were applicable to such payment and to such official or employee. The burden of proof in respect of the issue, for the purposes of this paragraph, as to whether a payment constitutes an illegal bribe or kickback (or would be unlawful under the laws of the United States) shall be upon the Secretary to the same extent as he bears the burden of proof under section 7454 (concerning the burden of proof when the issue relates to fraud).

(2) *Other illegal payments.*—No deduction shall be allowed under subsection (a) for any payment (other than a payment described in paragraph (1)) made, directly or indirectly, to any person, if the payment constitutes an illegal bribe, illegal kickback, or other illegal payment under any law of the United States, or under any law of a State (but only if such State law is generally enforced), which subjects the payor

section 162(c) through a set of hypothetical business transactions. Before turning to these transactions, it is useful to summarize the policies on which section 162(c) rests.

to a criminal penalty or the loss of license or privilege to engage in a trade or business. For purposes of this paragraph, a kickback includes a payment in consideration of the referral of a client, patient, or customer. The burden of proof in respect of the issue, for purposes of this paragraph, as to whether a payment constitutes an illegal bribe, illegal kickback, or other illegal payment shall be upon the Secretary to the same extent as he bears the burden of proof under section 7454 (concerning the burden of proof when the issue relates to fraud).

....

Before 1958 the deductibility of questionable payments to foreign officials was governed by the public policy doctrine. Under this nonstatutory doctrine, the Commissioner denied deductibility as business expenses to some expenditures that were otherwise ordinary and necessary within the meaning of § 162(a) but that violated a federal or state law or were incidental to such violation. The test of deductibility was how severely and immediately national or state policies would be frustrated if the deduction were allowed. *Tank Truck Rentals, Inc. v. Commissioner*, 356 U.S. 30, 34-36 (1958). Under the public policy doctrine the Commissioner generally disallowed bribes to foreign officials, but not without a significant exception:

Where . . . it is the foreign government itself which demands or acquiesces in the payment, so that legal recourse is not available to the taxpayer in the operation of his legal business, the Service would find it difficult to sustain the position that the expenses were not ordinary and necessary to the taxpayer's business.

Letter from Commissioner Harrington to Senator Williams, March 11, 1957, *reprinted in* 103 CONG. REC. 12418 (1957) (Sen. Williams). This exception did not apply, however, if the Commissioner concluded that the payment actually violated a state or federal law. *Id.*

In 1958, Senator Williams introduced a bill designed explicitly to deny deductibility for certain questionable foreign payments. 104 CONG. REC. 2028-29 (1958). The bill denied deductibility for payments to foreign government officials if the receipt of the payment would have been unlawful had United States law been applicable; it is now codified in the first sentence of § 162(c)(1). There is little evidence of the congressional intent underlying the foreign payments provision of § 162(c)(1). When introducing the bill, Senator Williams said that the public policy doctrine had been interpreted to permit deductibility for the payments he had in mind. 104 CONG. REC. 2028-29 (1958). He emphasized that he thought bribes and kickbacks were "wrong," *id.* at 2028, and that American foreign policy would be adversely affected if the United States were on record as "recognizing . . . the legitimacy or the propriety of an American corporation or individual bribing an official or employee of a foreign government." *Id.* at 2029. Finally, he noted the difficulty of proving that bribes had or had not been made. *Id.* The Senate report on the bill reflects only the first of these concerns: in its only explanation of why foreign bribes should not be deductible, the report states: "because the payment of similar kickbacks or bribes to a Federal official or employee would be unlawful." S. REP. NO. 1983, 85th Cong., 2d Sess. 125 (1958) [hereinafter cited as S. REP. NO. 85-1983].

The Tax Reform Act of 1976 reduced, in the amount of § 162(c)(1) payments, the availability of certain tax incentives relating to foreign income. First, American companies are ordinarily allowed to defer earnings of controlled foreign subsidiaries, I.R.C. § 995(a); the 1976 Act subjects to current taxation as a deemed dividend an amount equal to any § 162(c)(1) payment by a foreign subsidiary, I.R.C. § 952(a). Second, Domestic International Sales Companies (DISCs) are ordinarily allowed to defer earnings, I.R.C. § 995(b)(1) (D); the 1976 Act subjects to current taxation as a deemed dividend an amount equal to any § 162(c)(1) payment by a DISC, *id.* In addition, the 1976 Act does not allow the earnings and profits of foreign corporations to be reduced by the amount of § 162(c)(1) payments. I.R.C. § 964(a).

The legislative history of these provisions suggests only that Congress thought that it was wrong for taxpayers to receive tax benefits or incentives for engaging in morally undesirable behavior: "The committee does not believe that multinational corporations should benefit from tax incentives when they engage in misconduct." S. REP. NO. 938, 94th Cong., 2d Sess. 12 (1976) [hereinafter cited as S. REP. NO. 94-938].

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I. Policies Underlying Nondeductibility of Foreign Bribes and Similar Payments

Three policies underlie the nondeductibility of foreign bribes and similar payments: such payments are morally wrong; they adversely affect American foreign policy; and they result in unfair competition and possible misallocation of resources.

The view that bribes and similar payments are morally wrong has been basic to the various efforts to prohibit or discourage them.¹³ Discouraging immoral conduct through the tax system, however, may conflict with that system's function of raising revenue by taxing net income.¹⁴ These competing policies—discouraging immoral conduct and taxing net income—suggest not that questionable payments should automatically be nondeductible, but rather that the more reprehensible a payment, the less likely it will be deductible.

The second reason for the nondeductibility of foreign bribes and similar payments is that they adversely affect American foreign policy.¹⁵ American businesses are often identified abroad with the United States government, so that misbehavior by one tarnishes the other.¹⁶ Foreign governments may be embarrassed by revelations of bribes, and their affiliation with the United States may be weakened if the corrupting influence was from the United States.¹⁷ Bribery undermines our objective of promoting “democratically accountable governments and professionalized civil services in developing countries” and the free enterprise system in general.¹⁸ Moreover, recognizing such payments as ordinary and necessary business expenses would lend them an air of legitimacy, since it would appear to reflect at least tacit approval by the United States government. By denying deductibility and thus avoiding the appearance that the United States approves such payments, damage

13. See, e.g., H.R. REP. NO. 95-640, *supra* note 3, at 4; S. REP. NO. 94-938, *supra* note 12, at 12; 104 CONG. REC. 2028-29 (1958) (Sen. Williams). See also note 12 *supra*.

14. See, e.g., Commissioner v. Tellier, 383 U.S. 687, 691 (1966); Taggart, *Fines, Penalties, Bribes, and Damage Payments and Recoveries*, 25 TAX L. REV. 611, 614-15 (1970).

15. See H.R. REP. NO. 95-640, *supra* note 3, at 5 (bribes create “severe” foreign policy problems); S. REP. NO. 95-114, *supra* note 3, at 3 (“severe adverse effects”); 104 CONG. REC. 2028-29 (1958) (Sen. Williams); cf. S. REP. NO. 1031, 94th Cong., 2d Sess. 3-4 (1976) (bribery increases likelihood of hostile popular reaction to United States) [hereinafter cited as S. REP. NO. 94-1031]. This report accompanied S. 3664, which was passed unanimously by the Senate on Sept. 15, 1976, 122 CONG. REC. S15862 (daily ed. Sept. 15, 1976), and which was very similar to the foreign payments bill (S. 305) passed by the Senate in 1977. There are some differences between S. REP. NO. 94-1031 and S. REP. NO. 95-114, *supra* note 3, which accompanied S. 305; we note these differences when relevant.

16. See S. REP. NO. 95-114, *supra* note 3, at 3.

17. H.R. REP. NO. 95-640, *supra* note 3, at 5.

18. S. REP. NO. 94-1031, *supra* note 15, at 3-4; see H.R. REP. NO. 95-640, *supra* note 3, at 4.

to our foreign policy would be mitigated.¹⁹ This policy indicates that the more a payment threatens to interfere with United States foreign policy, the less likely it will be deductible.

Finally, bribes may result in unfair competition and misallocation of resources by allowing less efficient firms to obtain business or by encouraging firms to compete in the size of their bribes, rather than in the quality or cost of their products or services.²⁰ Although the most efficient business may be able to pay the highest bribes, this may not occur in practice due to imperfect information about bribes paid by competitors. Moreover, even if the most efficient business pays the highest bribe, it may not be awarded the contract if it bribed the wrong person. Allowing deductions to bribes would exacerbate the unfair competition because the real cost of a bribe to the payor would be decreased and bribes would then probably become larger and more frequent.²¹

On the other hand, discouraging bribery through the tax system creates a form of unfair competition between United States companies and foreign companies not subject to a provision like section 162(c). Thus the Commissioner may be more likely to allow a deduction if the taxpayer can show that competing businesses made similar payments in connection with the same transaction, that no unusual service or advantage was gained as a result of the payment, that the size of the payment suggests an insignificant misallocation of resources, or that the

19. It could be argued that, in denying deductibility for bribes, the United States would be viewed as intruding into the internal affairs of other countries. See SEC Report, *supra* note 1, at 61-62. Since most countries have laws prohibiting bribery, see Note, *supra* note 2, at 235 n.26, and would probably acknowledge that bribery is wrong, and since denying deductibility involves less intrusion than, for example, criminal penalties for bribes, this risk seems slight.

20. See H.R. REP. No. 95-640, *supra* note 3, at 4-5; S. REP. No. 95-114, *supra* note 3, at 4; Note, *supra* note 2, at 232.

Related to this consideration is the fact that a bribe is a transfer payment. In a bidding situation in which price is the only factor officially to be considered, the payment is transferred from the bidder to the recipient government official. In the more usual bidding situation, in which factors in addition to price are officially to be taken into account, or in which the bidding company includes the cost of the bribe in its initial bid, the payment is a transfer from the government to the recipient official. Because the official is presumably less likely than the government to invest in publicly oriented projects, the results of such a transfer are undesirable in the sense that the official's investments are less directed toward the public welfare.

21. See H.R. REP. No. 95-640, *supra* note 3, at 5; Note, *supra* note 2, at 251. So far as demand for payments is concerned, it can be argued that foreign officials attempting to extort payments will not be significantly deterred by sanctions that cannot affect them. See *Foreign Payments Disclosure: Hearings Before the Subcomm. on Consumer Protection and Finance of the House Comm. on Interstate and Foreign Commerce*, 94th Cong., 2d Sess. 109 (1976) (statement of J.T. Smith, General Counsel, Dep't of Commerce).

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payment is an accepted practice in the business community and in the view of the foreign government.²²

II. The Deductibility of Bribes, Kickbacks, and Extortion Payments

In order to assess the application of section 162(c) to different types of questionable foreign payments, we consider a hypothetical multinational corporation, Octopus, Inc., which has made a number of questionable foreign payments and now seeks to deduct them from income. Three payments in particular give rise to problems for the filing of Octopus's tax returns for the current year. These payments differ in certain respects, and, for the sake of convenience, we have labeled the first payment a bribe, the second a kickback, and the third an extortion payment.

The possible bribe arose when Octopus was one of several corporations to submit sealed bids for a contract to build a factory for the Ministry of Commerce of the Republic of Homos. After Octopus had submitted its bid, it was approached by a private sales agent known for

22. Three other reasons have been given for the nondeductibility of bribes, but none is persuasive. The first is the argument of Representative Nix that nondeductibility of foreign bribes is necessary to avoid unequal treatment of domestic companies, which must comply with United States antibribery laws and which cannot deduct payments that violate those laws, and foreign-operating companies, which would otherwise be able to deduct bribes paid abroad. Statement of Representative Nix, July 17, 1975 (on file with *Yale Law Journal*). But domestic and foreign-operating companies are not similarly situated except in the domestic market, where both must follow American antibribery laws. In foreign markets, the two sets of businesses are not in competition. Although the relative success of domestic and foreign-operating companies does affect their ability to attract investment capital, the effect of deductibility for bribes would probably be very small. Moreover, if equity is the goal, it should be remembered that foreign-operating companies are treated unequally vis-à-vis domestic companies because they are subject to the laws both of the United States and of the country in which they operate and that they may be treated unequally vis-à-vis their non-United States foreign competitors because the latter may not be subject to a provision like § 162(c).

A second reason given for the nondeductibility of bribes is that they are difficult to substantiate because records of bribes are likely to be meager. *See, e.g.*, 104 CONG. REC. 2028-29 (1958) (Sen. Williams). But this problem could better be solved directly via I.R.C. § 274(d), which requires adequate substantiation for deductions, or by the method used in deductions of "payola": the deduction is disallowed unless the taxpayer furnishes the Commissioner with the names and addresses of the recipients of the payments. 4A J. MERTENS, *LAW OF FEDERAL INCOME TAXATION* § 25.131, at 586 (1972 ed.). Such an approach might also discourage bribes from the recipients' perspective and would, at the very least, facilitate full taxation of the recipients (although tax revenues from recipients would probably not go to the United States treasury).

Third, it is occasionally argued that the general business reputation of United States firms is damaged by bribes and that this has effects such as harming the United States balance of payments position. *See, e.g.*, Note, *supra* note 2, at 232. Although it may be that bribes do harm the general reputation of United States firms, it is impossible to judge, on the basis of present data, the net effect that questionable foreign payments have had on the total foreign business of United States firms.

assisting foreign businesses in Homos. The agent, who was not related to any official or employee of the Homosian government, offered his services. For a \$100,000 commission he would "guarantee" that Octopus would win the contract. Octopus executives told him that they would think it over. Shortly thereafter, Octopus heard a fairly reliable rumor that it was the lowest bidder. Octopus decided that it was possible that it could lose the contract, even though it was the lowest bidder, because criteria other than price could be considered in awarding the contract (for example, whether the bidder is likely to perform adequately), and that \$100,000 would be a relatively meager sum in the event that the contract was awarded to it. Before reaching an agreement with the agent, Octopus executives asked him what he would do to assist Octopus. He replied that he would advise them on how to proceed with their bid and that he would contact the officials in charge of awarding the contract and attempt to persuade them that Octopus was the most reliable bidder. He also noted that he had a reputation for dealing successfully with Homosian officials and that he was familiar with the types of reasoning that had proven persuasive to them in the past. After signing an agreement with the agent that specified his services as just described, the Octopus executives gave the agent a check for \$100,000. Octopus was awarded the contract.

The possible kickback arose out of the same construction contract. Before signing the contract, the Homosian officials told Octopus that after the project had been completed and Octopus had been given its last payment, Octopus would be required to rebate \$150,000 to the Ministry of Commerce. Such a payment was not illegal in Homos. Octopus executives surmised that the Ministry was allocated monies for certain kinds of projects, but not for other projects that it would like to undertake. To secure funds for these other projects, the Ministry required rebates from its contractors. Octopus calculated that even after paying a \$150,000 rebate, it could still make a healthy profit. It agreed to the terms set by the Homosian officials, and after completion of the contract it delivered a \$150,000 check made out to the Ministry of Commerce.

The situation involving a possible extortion payment also occurred in Homos. Under its construction contract, Octopus had to ship large amounts of building materials through an overcrowded port. The government-operated harbor facilities were so inadequate that an average waiting time of sixty days was required before a newly arrived ship could be unloaded. It was well known, however, that some ships were unloaded in thirty days or less, while others with similar cargos were

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unloaded after ninety days or more. When the first ship carrying Octopus's materials arrived at the harbor, its captain was approached by the harbormaster, a middle-level official of Homos. The harbormaster described the procedures for mooring in the harbor. He also explained some of the customs of Homos "so that the captain and crew would feel welcome and comfortable during their visit." One such custom was the exchanging of gifts. Indeed, before the harbormaster left he gave the captain a small Homosian vase. Time was of the essence for the Octopus construction contract. So, after waiting sixty-two days to be unloaded, Octopus executives decided to give the harbormaster a modest \$200 gift of American greenbacks. Octopus's building materials were immediately unloaded.

As luck would have it, after covering all expenses, including the \$100,000 sales commission, the \$150,000 kickback, and the \$200 gift to the harbormaster, Octopus still had a large net profit from its contract. Now, Octopus wants to know whether any of these three payments is deductible as a business expense for United States income tax purposes. Although the three payments do pose some common issues, at the outset it is most fruitful to analyze them separately.

A. *The Bribe*

Section 162(a) of the Internal Revenue Code allows "as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." We may assume that the \$100,000 "commission" paid to the agent is "ordinary and necessary" within the meaning of section 162(a),²³ and there is no question that Octopus is carrying on a trade or business. The critical question, then, is whether the \$100,000 "commission" falls within the scope of section 162(c), which disallows deductions for certain bribes, kickbacks, and other payments.

The \$100,000 payment does not fall within the terms of section 162(c)(2), which provides:

Other illegal payments.—No deduction shall be allowed under subsection (a) for any payment (other than a payment described in paragraph (1)) made, directly or indirectly, to any person, if the payment constitutes an illegal bribe, illegal kickback, or other

23. Throughout this discussion, it will be assumed that the payments are "ordinary and necessary" within the meaning of § 162(a), so that if they are not disallowed under § 162(c) they would also not be disallowed under § 162(a) either. Some payments beyond the reach of § 162(c) may, of course, be nondeductible because they are so extraordinary or so unnecessary as to fall outside the broad test of deductibility under § 162(a). See pp. 1114, 1117 *infra*.

illegal payment under any law of the United States, or under any law of a State (but only if such State law is generally enforced), which subjects the payor to a criminal penalty or the loss of license or privilege to engage in a trade or business. For purposes of this paragraph, a kickback includes a payment in consideration of the referral of a client, patient, or customer. The burden of proof in respect of the issue, for purposes of this paragraph, as to whether a payment constitutes an illegal bribe, illegal kickback, or other illegal payment shall be upon the Secretary to the same extent as he bears the burden of proof under section 7454 (concerning the burden of proof when the issue relates to fraud).

The payment does not fall within this provision because the \$100,000 "commission" would be illegal only if part or all of it were used to bribe the Homosian officials. Yet section 162(c)(2) is not applicable to payments to foreign officials. Section 162(c)(2) is entitled "[o]ther illegal payments" and by its terms refers only to payments "other than a payment described in [section 162(c)(1)]." Since section 162(c)(1) covers direct or indirect payments "to an official or employee of a foreign government," section 162(c)(2) does not cover such payments.²⁴

If the payment is to be disallowed as a deduction, then, it will have to come within the prohibition of section 162(c)(1), which provides:

Illegal payments to government officials or employees.—No deduction shall be allowed under subsection (a) for any payment made, directly or indirectly, to an official or employee of any government, or of any agency or instrumentality of any government, if the payment constitutes an illegal bribe or kickback or, if the payment is to an official or employee of a foreign government, the payment would be unlawful under the laws of the United States if such laws were applicable to such payment and to such official or employee. The burden of proof in respect of the issue, for the purposes of this paragraph, as to whether a payment constitutes an illegal bribe or kickback (or would be unlawful under the laws of the United States) shall be upon the Secretary to the same extent as he bears the burden of proof under section 7454 (concerning the burden of proof when the issue relates to fraud).

Section 162(c)(1) establishes two tests of deductibility: (1) whether the payment is actually illegal and (2) whether the payment is hypothet-

24. See S. REP. No. 552, 91st Cong., 2d Sess. 274-75 (1969) [hereinafter cited as S. REP. No. 91-552]. See also Alfred, *Corporate Slush Funds: The Deductibility of "Sensitive" Payments*, 4 J. CORP. TAX 130, 138 (1977).

For discussions of § 162(c)(2), see Note, *Deductibility of Overseas Commercial Bribes*, 13 COLUM. J.L. & SOC. PROB. 235 (1977); Note, *Federal Income Taxation—Public Policy and the Deductibility of Kickbacks Under § 162(c)(2)*, 35 OHIO ST. L.J. 686 (1974).

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ically illegal. The hypothetical illegality test clearly applies to payments to officials or employees of a foreign government. It is arguable that the actual illegality test also applies to such payments,²⁵ but the question is solely academic. The regulations²⁶ and legislative his-

25. There are two possibilities for such an application, one directly via the first clause of § 162(c)(1) and another implicitly via the hypothetical illegality test. The actual illegality test in the first clause of § 162(c)(1) appears on its face to apply to such payments because it covers, *inter alia*, payments "to an official or employee of any government" (emphasis added). Under this interpretation, the hypothetical illegality test supplements, rather than replaces, the actual illegality test so far as it concerns officials or employees of a foreign government. The difficulties with this interpretation are, first, that Treasury Regulation § 1.162-18(a)(1)(i), which concerns the actual illegality test, specifically includes payments only to "an official or employee of a government *other than a foreign government*" (emphasis added). That regulation also omits any reference to payments to agencies or instrumentalities of any government (foreign or domestic), which are included in § 162(c)(1), but the omission of payments to foreign government officials or employees is clearly deliberate. Moreover, such an omission appears consistent with legislative intent. The 1969 Senate Report on the amendments creating the actual illegality test in the first clause of § 162(c)(1) specifies that the test for deductibility of payments to foreign government officials or employees would remain as it was under the original 1958 enactment, *i.e.*, "whether the payment would be unlawful under U.S. laws, were U.S. laws applicable to the payment." S. REP. NO. 91-552, *supra* note 24, at 275. Thus the first clause of § 162(c)(1) does not make payments to foreign government officials or employees subject to the actual illegality test.

The Commissioner could argue that illegal payments to foreign government officials and employees are included implicitly in the hypothetical illegality test of the second clause of § 162(c)(1). That is, the payments to such persons that are actually illegal are merely a subset of those payments that are hypothetically illegal, since the Commissioner could either (1) disregard the fact that the Foreign Corrupt Practices Act actually applies and analyze it for tax purposes via a legal fiction as if it did not, or else (2) argue that the "would be unlawful" language includes both hypothetical and actual illegality. Legal fictions are generally disfavored, so it is doubtful that the Commissioner would prevail on that ground, but the second argument may be persuasive. Although the subjunctive mood normally implies a contrary-to-fact situation, it is arguable that it could be interpreted to include both categories, especially when the underlying policies so indicate, as is the case here: at least the morality and foreign relations policy bases for denying deductibility for bribes argue more strongly for denying deductibility to actually illegal bribes than to hypothetically illegal bribes. On the other hand, Congress could not have intended this result in either 1958 or 1969, because foreign bribes were not then proscribed by United States law (although it is arguable Congress would have intended such a result if it had addressed the issue). Because it would be so anomalous in terms of the policies underlying § 162(c)(1) to allow a deduction for an illegal bribe while denying deductibility to a legal but hypothetically unlawful bribe, it is probable that a court would find that the actual illegality test was implicit in the hypothetical illegality test, if forced to do so in order to deny a deduction for an actually illegal bribe.

26. The relevant regulation provides:

(a) *Illegal payments to government officials or employees*—(1) *In general.* No deduction shall be allowed under section 162(a) for any amount paid or incurred, directly or indirectly, to an official or employee of any government, or of any agency or other instrumentality of any government, if—

(i) In the case of a payment made to an official or employee of a government other than a foreign government described in subparagraph (3)(ii) or (iii) of this paragraph, the payment constitutes an illegal bribe or kickback, or

(ii) In the case of a payment made to an official or employee of a foreign government described in subparagraph (3)(ii) or (iii) of this paragraph, the making of the payment would be unlawful under the laws of the United States (if such laws were

tory²⁷ strongly suggest that legality or illegality under *foreign* law is irrelevant. As far as United States law is concerned, the Foreign Corrupt Practices Act, which is the only statute that directly proscribes foreign bribes, appears to be sufficiently narrow so that any payment it makes illegal would also be hypothetically illegal under the statutes that prohibit bribery of United States government officials or employees.²⁸ Thus Octopus can deduct the agent's commission only if it passes the hypothetical illegality test.²⁹ That test denies deductibility for a payment to an official or employee of a foreign government if "the payment would be unlawful under the laws of the United States if such laws were applicable to such payment and to such official or employee."

The hypothetical illegality test incorporates by reference the criminal laws of the United States.³⁰ Bribery is specifically outlawed by federal statute,³¹ and thus a direct or indirect payment to a foreign official to influence his action would not be deductible. The central problem facing Octopus in preparing its tax return is that it does not know whether any of its payment to the agent ended up in the hands of

applicable to the payment and to the official or employee at the time the expenses were paid or incurred).

No deduction shall be allowed for an accrued expense if the eventual payment thereof would fall within the prohibition of this section. The place where the expenses are paid or incurred is immaterial. *For purposes of subdivision (ii) of this subparagraph, lawfulness or unlawfulness of the payment under the laws of the foreign country is immaterial.*

Treas. Reg. § 1.162-18(a)(1) (emphasis added).

27. S. REP. NO. 85-1983, *supra* note 12, at 125.

28. The Act prohibits only bribery that involves use of the mails or other means or instrumentalities of interstate commerce. Pub. L. No. 95-213, §§ 103(a), 104(a), 91 Stat. 1495, 1496 (to be codified at 15 U.S.C. §§ 78dd-1, 78ff). The domestic antibribery statute, 18 U.S.C. § 201 (1970), does not include any such requirement. Moreover, the Act does not apply to bribes of foreign officials "whose duties are essentially ministerial or clerical," Pub. L. No. 95-213, §§ 103(a), 104(d), 91 Stat. 1496, 1498 (to be codified at 15 U.S.C. §§ 78dd-1, 78dd-2), or to bribes whose purpose is not to obtain, retain, or direct business, Pub. L. No. 95-213, §§ 103(a), 104(a), 91 Stat. 1495-97 (to be codified at 15 U.S.C. §§ 78dd-1, 78dd-2). Again, 18 U.S.C. § 201 (1970) does not exempt such bribes. Finally, the Act does not apply to payments by foreign subsidiaries, *see* H. CONF. REP. NO. 95-831, *supra* note 3, at 14. Such payments would be unlawful if 18 U.S.C. § 201 (1970) applied.

It may be that certain acts proscribed by the Act—for example, payments to foreign political parties or officials thereof or candidates for foreign political office—would not be unlawful under United States laws. Assuming this to be the case, such payments are not payments to officials or employees of a foreign government and thus would be dealt with under § 162(c)(2) rather than under § 162(c)(1).

29. There is nothing in the language of § 162(c)(1) to prevent the nondeductibility of a hypothetically illegal payment merely because it also happens to be actually illegal under a different statute.

30. Treasury Regulations define the term "laws of the United States" to include "only Federal statutes, including State laws which are assimilated into Federal law by Federal statute, and legislative and interpretative regulations thereunder. The term shall also be limited to statutes which prohibit some act or acts, for the violation of which there is a civil or criminal penalty." Treas. Reg. § 1.162-18(a)(4).

31. 18 U.S.C. § 201 (1970).

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Homosian officials or, if so, whether its payment would be considered an illegal bribe.

The circumstances do suggest, of course, that at least some of the agent's commission may have reached the outstretched palms of government officials. In one view, the sum of \$100,000 seems quite large in relation to the agent's undertaking to advise Octopus and to attempt to persuade the Homosian officials. Notably, the agent played no role in putting together the Octopus bid or in introducing Octopus to the Homosian bureaucracy during the initial stages of bidding. On the other hand, the use of agents or commercial representatives is widespread and often a virtual necessity;³² the work involved may stretch over many months and may involve employees of the agent; both parties may find it advantageous to set the price before the amount of work required becomes known; and there may well be a seller's market in the knowledge of the local culture and bureaucracy and the political judgment legitimately utilized in facilitating commercial transactions in foreign countries. This is especially true in developing countries, where amorphous criteria such as "economic development"³³ or "public interest"³⁴ must often be satisfied before an investment project or contract can be approved by the government.

Although the use to which the \$100,000 payment was put is not clear, the amount of the payment was probably large enough that it raised, or should have raised, a suspicion in the minds of Octopus executives that the agent was using part of his payment from Octopus to bribe Homosian officials. With its honest suspicions, but without conclusive facts or reason to know one way or the other, can Octopus deduct its payment to the agent?³⁵ Unfortunately, the Code, regulations, legislative history, policy considerations, and criminal statutes do not provide a clear answer.

1. *The Code*

Section 162(c)(1) prohibits deductions for direct or indirect payments to Homosian officials if such payments would be unlawful under

32. See generally Shamma & Morrison, *The Use of Local Representatives in Saudi Arabia*, 11 INT'L LAW. 453 (1977); see also Note, *supra* note 2, at 238 n.43.

33. See Shamma & Morrison, *supra* note 32, at 456.

34. In certain countries, patents cannot be granted on inventions deemed contrary to public or social interest. UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT, *THE ROLE OF THE PATENT SYSTEM IN THE TRANSFER OF TECHNOLOGY TO DEVELOPING COUNTRIES*, UNCTAD TD/B/AC.11/19/ Rev. 1, ¶ 346, 348-50 (1975).

35. We do not consider whether Octopus would have the obligation under some circumstances to ascertain the way in which the agent disposed of his sales commission, or assuming that some obligation might exist, the extent to which Octopus would be required to go behind representations made by the agent.

United States law. Any part of Octopus's payment to the agent that did reach Homosian officials cannot be considered a direct payment to those officials because Octopus did not itself pay the officials or tell the agent to do so. Whether the payment to the agent could be considered an indirect payment to Homosian officials is not answered by the Code. In construing the term "indirectly" in other sections of the Code, courts have held that the term is to be given a broad reading unless the legislative history shows that Congress intended the section to have a restricted application.³⁶ Such a restrictive intent has been found regarding only one section containing this term.³⁷ The legislative history of section 162(c)(1) gives no indication of a restrictive intent,³⁸ and it seems certain that the courts would construe "indirectly" to include any payment that has the same effect as a payment made directly.³⁹ Even a broad interpretation of the term "indirectly," how-

36. See, e.g., *McWilliams v. Commissioner*, 331 U.S. 694 (1947); *Charles Town, Inc. v. Commissioner*, 372 F.2d 415 (4th Cir.), cert. denied, 389 U.S. 841 (1967); *Ach v. Commissioner*, 358 F.2d 342 (6th Cir.), cert. denied, 385 U.S. 899 (1966); *Young & Rubicam, Inc. v. United States*, 410 F.2d 1233 (Ct. Cl. 1969).

37. See *Semel v. Commissioner*, 33 TAX CT. MEM. DEC. (CCH) 248, 252 (1974) (I.R.C. § 1239); *10-42 Corp. v. Commissioner*, 55 T.C. 593, 598 n.4 (1971) (not acquiesced in on this issue, 1972-2 C.B. 4) (same).

38. See pp. 1094-97 *supra*.

39. The relevant regulation also suggests that "indirectly" will be broadly construed:

(2) *Indirect payment*. For purposes of this paragraph, an indirect payment to an individual shall include any payment which inures to his benefit or promotes his interests, regardless of the medium in which the payment is made and regardless of the identity of the immediate recipient or payor. Thus, for example, payment made to an agent, relative, or independent contractor of an official or employee, or even directly into the general treasury of a foreign country of which the beneficiary is an official or employee, may be treated as an indirect payment to the official or employee, if in fact such payment inures or will inure to his benefit or promotes or will promote his financial or other interests. A payment made by an agent or independent contractor of the taxpayer which benefits the taxpayer shall be treated as an indirect payment by the taxpayer to the official or employee.

Treas. Reg. § 1.162-18(a)(2).

This definition of "indirect payment" is an expansion of the pre-1975 definition. Compare Treas. Reg. § 1.162-18 (1975) (current version) with Treas. Reg. § 1.162-18, T.D. 6448, 1960-1 C.B. 54-55 (pre-1975 version). Added to the pre-1975 definition were the terms "relative" and "independent contractor" of a government official or employee, the reference to "payor" in the first sentence, and the last sentence, which mentions agents and independent contractors of the taxpayer. The regulation as it now stands is so broad that serious difficulties may arise in applying it fairly. For example, payments to any "relative" (a term that is nowhere limited to members of the immediate family) of a government official or employee potentially fall within the regulation. The broad interpretation generally given "indirectly," see note 36 *supra*; the phrase "inures to or is promotional of"; the close scrutiny with which the Commissioner examines intrafamily relationships in other contexts; and the well-known propensity for nepotism among powerful groups in some countries indicate that payments to relatives could be considered indirect payments even before 1975. The fact that "relatives" were not specifically flagged under the original regulation, however, may reflect the extreme difficulties of distinguishing payments to relatives that are deductible from those that are not. This is especially

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ever, tells little about how Octopus's payment fares under the hypothetical illegality test.

Yet the last sentence of section 162(c)(1) suggests that in the absence of conclusive evidence a deduction will be allowed. "The burden of proof . . . as to whether a payment constitutes an illegal bribe or kickback (or would be unlawful under the laws of the United States) shall be upon the Secretary . . ." Under this standard, the Commissioner must prove that a payment is a nondeductible bribe or kickback by clear and convincing evidence.⁴⁰

2. *The Regulations*

The regulations declare that a payment made without the payor's knowledge or suspicion that any part of the payment will be used as a bribe will still be disallowed as a deduction if "*in fact*" such payment inures to the benefit of a government official.⁴¹ This indicates an objective, after-the-fact test.

Such an after-the-fact test is not consistent with the Code. The Code requires that, in order to be nondeductible, a payment be an illegal bribe or kickback or be unlawful under United States laws if such laws were applicable. The test of deductibility, therefore, necessarily incorporates the test of legality under United States criminal law. As is discussed below, the applicable criminal statutes require that the payor have at least some level of knowledge or intent that the payment is to be passed on to a government official.⁴² By making a payment nondeductible because it is ultimately used to bribe a government official even when the initial payor does not know or have reason to know that the payment will be used in this fashion, the regulation fails to implement Congress's mandate in a reasonable manner and is therefore invalid.⁴³

Moreover, even assuming that the regulation is valid, it does not give Octopus any concrete guidance. Octopus still does not know whether any of the payment "*in fact*" reached or inured to the benefit of government officials.

true in societies where joint families are common, which increases the likelihood of a payment "inuring to the benefit of" a relative, or where families involved in powerful positions in the government are also likely to be similarly involved in other sectors of the economy, which increases the likelihood that a purely commercial transaction will involve relatives of government officials.

40. Treas. Reg. § 1.162-18(b)(4).

41. See note 39 *supra*.

42. See pp. 1110-12 *infra*.

43. See *United States v. Correll*, 389 U.S. 299, 307 (1967).

3. *Legislative History*

The legislative history of section 162(c) is inconclusive on the deductibility of Octopus's payment. The section was originally enacted primarily to discourage behavior that Congress viewed as "wrong" or "immoral."⁴⁴ "Wrongfulness" and "immorality" are not defined in the legislative history, nor is the hypothetical illegality test explained.

Subsequent amendments to section 162(c) similarly afford little guidance. The Tax Reform Act of 1969⁴⁵ amended section 162 and effectively overruled the public policy doctrine, which the Commissioner had used to disallow deductions for expenses thought to contravene sharply defined public policies, even though the Code did not specify that such expenses were nondeductible.⁴⁶ The 1969 amendments disallowed deductions for treble damages awarded in antitrust suits, fines for violations of laws, bribes to public officials, and other unlawful bribes and kickbacks.⁴⁷ The fact that Congress chose to isolate four specific kinds of expenses to disallow as deductions indicates that other expenses would be deductible.⁴⁸ Octopus might argue from this statutory pattern of tightly circumscribed exceptions to the general deductibility of business expenses that doubts are to be resolved in favor of deductibility. But the Commissioner could argue that notions of public policy should be used to define the reach of the four statutory exceptions to deductibility, even if the old public policy doctrine can no longer be used to create new exceptions. On this view, even if the application of section 162(c)(1) is unclear, it should be used to disallow deductions for payments that have the same effect as those specifically disallowed. Such an approach would also be consistent with the broad construction of "indirect" payments that appears to be warranted under the Code.⁴⁹

When section 162(c)(2) was amended in 1971, changes were not made in section 162(c)(1). The amendment of section 162(c)(2) was

44. See pp. 1094-95 *supra*.

45. Pub. L. No. 91-172, § 902, 83 Stat. 710-11 (1969).

46. See note 12 *supra*.

47. Tax Reform Act of 1969, Pub. L. No. 91-172, § 902, 83 Stat. 710-11 (1969).

48. Some legislative history supports this inference. The Senate Report stated: "The provision for the denial of the deduction for payments in these situations which are deemed to violate public policy is intended to be all inclusive. Public policy, in other circumstances, generally is not sufficiently clearly defined to justify the disallowance of deductions." S. REP. No. 91-552, *supra* note 24, at 274. A recent amendment to the regulations also indicates that a deduction for otherwise allowable business expenses will not be denied on grounds of conflict with sharply defined public policy. Treas. Reg. § 1.162-1(a) (as amended by T.D. 7345 (1975)).

49. See p. 1104 *supra*.

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intended to disallow deductions previously allowed.⁵⁰ On the one hand, the Commissioner could argue from the amendment to section 162(c)(2) that Congress intended section 162(c) generally to have a broad coverage and that doubts about its coverage should therefore be resolved against deductibility. On the other hand, Octopus could argue that, because section 162(c)(2) was amended but section 162(c)(1) was not, the latter should not be so broadly construed. Neither argument is especially persuasive; it is doubtful that the 1971 amendment to section 162(c)(2) has any significant implications for the interpretation of section 162(c)(1).

4. *Policy Considerations*

The Commissioner or Octopus might also turn to the policy considerations disfavoring bribes—that bribes are “wrong,” that they may adversely affect United States foreign policy, and that they cause unfair competition and possible misallocation of resources—in determining whether Octopus’s payment to the agent should be deductible. If indeed Octopus’s agent made any payments to Homosian officials, both the nature and the amount of those particular payments are relevant to the relationship between these policy considerations and the deductibility of the payment in question.

Analyzing the agent’s payments with respect to the first policy consideration, that bribes are “wrong,” is difficult because Congress did not explain why it thought that bribes were “wrong.” Several approaches could be taken to assessing the wrongfulness of a payment. One could argue that the agent’s payments are less objectionable than payments intended to influence decisions about more vital interests of the country involved, such as national security. Still, the tendency of these payments to corrupt⁵¹ is no less than that of other payments, and the fact that these payments may be less objectionable than others offers no guidance as to whether they are deductible so long as the other payments are not deductible. A second possible approach is that, because Octopus submitted the low bid, it was entitled to the contract even without the payments.⁵² Because criteria other than price could be considered in awarding the contract, however, no such claim is likely to be provable. Finally, one could focus on the amount of the payments,

50. S. REP. NO. 437, 92d Cong., 1st Sess. 72-73 (1971); 117 CONG. REC. 45854 (1971) (Rep. Mills); see p. 1100 *supra*.

51. A payment’s tendency to corrupt is best viewed as both an element of that payment’s “wrongfulness” and as a reason why it may adversely affect United States foreign policy. See S. REP. NO. 94-1031, *supra* note 15, at 3-5; pp. 1095-96 *supra*.

52. See pp. 1118-19 *infra*.

even though their amount is irrelevant in the sense that if a payment is "wrong" in the abstract, it is "wrong" no matter what its amount. In practical terms, however, a large payment is more likely to influence its recipient and therefore has a greater tendency to corrupt than a small payment has. Because the agent's payments could be as high as \$100,000,⁵³ Octopus cannot argue that the payments must have been so small that they had no significant tendency to corrupt their recipients. And even that argument would run afoul of the view that all bribes are "wrong." The Commissioner, on the other hand, cannot argue that the amount is so large as to be extremely reprehensible, because the amount of the payments is unknown. In sum, then, the policy consideration that bribes are "wrong" provides no clear guidance in determining whether Octopus should be allowed to deduct all its payments to the agent.

The second policy consideration, that bribes may adversely affect United States foreign policy, also provides no significant guidance. First, on this consideration deductibility should depend on a payment's relation to the laws and mores of the country involved—according to which that country's reaction to the bribe will be determined—rather than on its hypothetical illegality under United States law.⁵⁴ Yet such reference to foreign law is declared by the regulations⁵⁵ and legislative history⁵⁶ to be irrelevant. Second, payment-by-payment analysis of the effect on United States foreign policy would be unworkable (even disregarding the foreign law question) because the effect of a given payment can only be conjectured.⁵⁷

The situation is similar with respect to the third policy consideration, that bribes cause unfair competition and possible misallocation

53. The amount of the agent's payments is, of course, unknown in this hypothetical example. Assuming that he did make payments, however, it is doubtful that he would pay out more than he received from Octopus, even to preserve his reputation as a successful agent, without at least attempting to obtain more funds from Octopus.

54. United States law should be relevant only to the extent that foreign reaction may be influenced by whether the deduction would be disallowed if the payment had been made to an American official or by any tacit approval of the payment that deductibility implies.

55. Treas. Reg. § 1.162-18(a)(2).

56. S. REP. NO. 85-1983, *supra* note 12, at 125.

57. For example, the Commissioner might argue that the payments contravene the objective of promoting the free enterprise system. *See* S. REP. NO. 94-1031, *supra* note 15, at 3-4. Octopus could respond that, if this is true, it is true of all bribes, and that it may be less true here because Octopus was the low bidder. The amount of the payments is not directly significant because their effect on foreign policy depends on their influence, not on their size. On the other hand, a large bribe is more likely to be influential than a small bribe and is also more likely to attract widespread publicity if disclosed. The possible amount involved in the agent's payments does not allow Octopus to argue that the amount is so small as to be clearly unimportant or unlikely to attract publicity if disclosed, nor do the known facts allow the Commissioner to argue the converse.

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of resources. Octopus could argue that the other bidders or their agents also paid bribes to the Homosian officials. But this would probably be impossible to prove, and, even if provable, resources may still have been misallocated to the extent that Octopus is less efficient than the bidder that would have been awarded the contract had the bribe not been made. An argument by Octopus that no misallocation occurred because it was entitled to the contract as the low bidder would also fail, because it would be difficult to prove the influence of criteria other than price in awarding the contract. Moreover, Octopus cannot argue that any unfairness in competition that did occur had to have been *de minimis*, because the possible amount of the bribe remains large and the contract amount is even larger. The Commissioner, on the other hand, cannot use this consideration unless he knows details of the payments, which we assume that, since any bribe was paid by the agent, neither he nor Octopus knows, at least prior to filing.⁵⁸

5. *The Criminal Law*

Because the test of deductibility depends on the hypothetical illegality of a payment under United States criminal laws, Octopus's tax lawyers will have to consult criminal statutes and cases to determine the proper treatment of the payment to the agent. After doing so, they can conclude only that the test for deductibility under section 162(c)(1) is confusing and uncertain.

Two different issues confront Octopus's lawyers. First, assuming that when Octopus paid the \$100,000 to the agent it intended to influence Homosian officials improperly and thus that Octopus had the intent requisite for criminal liability under United States law, is the payment nevertheless deductible if Octopus later discovers that none of the money actually reached the hands of Homosian officials? In *United States v. Jacobs*,⁵⁹ the Second Circuit held that the antibribery statute⁶⁰

58. For a discussion of Octopus's obligations if it later discovers that the agent paid Homosian officials, see p. 1112 *infra*.

59. 431 F.2d 754 (2d Cir. 1970), *cert. denied*, 402 U.S. 950 (1971).

60. 18 U.S.C. § 201(b) (1970) provides:

Whoever, directly or indirectly, corruptly gives, offers or promises anything of value to any public official or person who has been selected to be a public official, or offers or promises any public official or any person who has been selected to be a public official to give anything of value to any other person or entity, with intent—

(1) to influence any official act; or

(2) to influence such public official or person who has been selected to be a public official to commit or aid in committing, or collude in, or allow, any fraud, or make opportunity for the commission of any fraud, on the United States; or

(3) to induce such public official or such person who has been selected to be a public official to do or omit to do any act in violation of his lawful duty . . . [shall be fined or imprisoned].

could be violated even though the official to whom the bribe was offered was not corrupted thereby, the object of the bribe could not be obtained, or there had not been an actual occasion to seek to influence official conduct.⁶¹ Thus the intent to bribe, when coupled with acts sufficient to constitute an attempt to do so, appears to be enough to support a criminal conviction. Here, if Octopus had the requisite intent when it paid the agent, the antibribery statute would support a conviction for attempted bribery if such laws were applicable. The act of paying the agent was not merely preparatory activity, because it was the last act that Octopus would have had to do to carry out its intended bribe. If paying the agent would have been illegal, then the payment would not be deductible, regardless of whether the agent actually bribed anyone.

The second question is more difficult: what is the level of intent required for criminal liability? The statutory provisions that might be applicable to the payment appear to have different requirements. One provision, 18 U.S.C. section 201(b),⁶² has been interpreted to require "corrupt intent to influence or be influenced in official conduct."⁶³ Another provision, 18 U.S.C. section 201(f),⁶⁴ appears to require a lesser degree of intent. In *United States v. Irwin*,⁶⁵ the Second Circuit approved jury instructions that stated that this section requires neither the "evil" or "corrupt" intent required by 18 U.S.C. section 201(b) nor an "intent to influence the public official" to whom the payment was made.⁶⁶ The full meaning of the instructions is somewhat cloudy because they also stated that the defendant must "willingly and knowingly, that is, intentionally as distinguished from inadvertently or negligently" have given money "because of official acts performed or to be performed [by the recipient]."⁶⁷

In a later case, *United States v. Barash*,⁶⁸ the Second Circuit seemed

61. 431 F.2d at 759-60. Cf. H.R. REP. No. 95-640, *supra* note 3, at 8 (term "corruptly" does not require that act be fully consummated or succeed in its purpose); S. REP. No. 95-114, *supra* note 3, at 10 (same).

62. See note 60 *supra*.

63. *United States v. Anderson*, 509 F.2d 312, 329 (D.C. Cir. 1974), *cert. denied*, 420 U.S. 991 (1975).

64. 18 U.S.C. § 201(f) (1970) provides:

Whoever, otherwise than as provided by law for the proper discharge of official duty, directly or indirectly gives, offers, or promises anything of value to any public official, former public official, or person selected to be a public official, for or because of any official act performed or to be performed by such public official, former public official, or person selected to be a public official . . . [shall be fined or imprisoned].

65. 354 F.2d 192 (2d Cir. 1965), *cert. denied*, 383 U.S. 967 (1966).

66. *Id.* at 197 n.3.

67. *Id.*

68. 365 F.2d 395, 401-02 (2d Cir. 1966).

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to suggest that 18 U.S.C. section 201(b) required specific intent, whereas 18 U.S.C. section 201(f) did not. *Barash* involved, in part, a prosecution under 18 U.S.C. section 201(f) for payments allegedly made by the defendant to Internal Revenue agents for favorable audits of the defendant's clients. At a second trial, the defendant testified that the acts charged in the complaint consisted of a payment made because of the defendant's sympathy for an agent's economic situation, Christmas gifts to create a better working atmosphere, and a gratuitous lunch after the conclusion of an audit. On the second appeal, the court clearly stated that "criminal intent" was required, but that "specific intent" was not, and that "[i]n measuring intent, it matters not whether the payments were made because of economic duress, a desire to create a better working atmosphere, or appreciation for a speedy and favorable audit."⁶⁹ This suggests—albeit not too clearly—that the level of requisite intent is not very high.

The Ninth Circuit has held, however, that the evidence in a prosecution under 18 U.S.C. section 201(f) "must show that something of value was given 'a public official . . . for or because of any official act performed or to be performed by such public official'."⁷⁰ And the District of Columbia Circuit has specifically held that 18 U.S.C. section 201(g), which forbids the receipt of payments illegal under section 201(f), requires a higher degree of intent than that evidenced in *Barash*, at least regarding payments to elected officials: the defendant must have intended to receive the payment " 'otherwise than as provided by law for the proper discharge of official duties . . . for or because of any official act performed or to be performed by him'."⁷¹ Thus the Ninth Circuit and the District of Columbia Circuit both seem to require a higher degree of intent than does the Second Circuit. According to this standard, which seems to be correct given the language of the statute, the general intent to make a payment to a government official would not suffice.

The statutes and cases do not provide a clear definition of the intent required for criminal liability, and the Code's incorporation of criminal statutes into its test for deductibility unfortunately incorporates the vagueness of those statutes as well. Vague definitions of intent are undesirable in the criminal context, but may be acceptable because of the desire to deter persons from conduct near the borders of criminality. Such vagueness, however, is even less favored in the tax context, where

69. *United States v. Barash*, 412 F.2d 26, 29 (2d Cir.), *cert. denied*, 396 U.S. 832 (1969).

70. *United States v. Alessio*, 528 F.2d 1079, 1082 (9th Cir. 1976).

71. *United States v. Brewster*, 506 F.2d 62, 76 (D.C. Cir. 1974); *see id.* at 72 n.26.

predictability is important in tax planning and where one major purpose of permitting deductions is to tax accurately a person's net income.

In summary, the statutes and cases do not provide a definition of intent that tells clearly whether Octopus must refrain from deducting a portion of its payment to the agent and, if so, how much. Especially because improper deductions can lead to criminal penalties or penalties for fraud or negligent disregard,⁷² the requisite intent should be at least that the principal should have known that the agent would pay government officials. Octopus probably did not have sufficient reason to know that this would occur. And even if it did have sufficient reason, it still would not know the probable or actual amounts of such payments, so the amount Octopus should refrain from deducting would also be unknown.

6. *Timing of the Return*

In deciding whether its payment to the agent is deductible, Octopus may face questions that revolve around the timing of filing its return. Suppose, for example, that at the time it made its payment to the agent, Octopus had no reason to believe that the payment would be used by the agent as a bribe. Shortly thereafter, but before Octopus files its return, it discovered that the agent did use a part of the payment to bribe some Homosian officials. Can Octopus deduct the payment? Another question might arise after Octopus has filed its return. Suppose Octopus properly claims a deduction in light of the facts of which it was aware at the time it filed its return, but later discovers that the agent had bribed officials with Octopus's money. Would Octopus have an obligation to file an amended return?

Under the present statute the answer to both questions is deceptively simple. Section 162(c)(1) makes deductibility depend on hypothetical illegality. Such illegality depends in turn on Octopus's intent at the time of payment, not on the factual circumstances that might ultimately develop. Thus in both situations the payment to the agent would be deductible.

72. A taxpayer (including an officer or employee of a corporate taxpayer) who willfully attempts to evade or defeat the payment of income taxes is guilty of a felony and subject to imprisonment for five years, a \$10,000 fine, or both, together with the costs of prosecution. I.R.C. § 7201. A willful failure to pay any tax, file a return, keep records, or supply information is a misdemeanor. I.R.C. § 7203. A penalty of 50% of the underpayment is assessed when any part of the underpayment was due to fraud. I.R.C. § 6653(b). A penalty of five percent of the underpayment may be imposed for negligent or intentional disregard of the tax rules and regulations. I.R.C. § 6653(a).

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B. *The Kickback*

Octopus's second payment might be characterized as a \$150,000 kickback to the Ministry of Commerce of Homos. If this payment were unlawful under United States law—which it probably is not⁷³—then it would be nondeductible under the first part of section 162(c)(1), which denies deductibility for illegal bribes or kickbacks paid to an official, employee, agency, or instrumentality of any government. Notice, however, that the applicable regulation is narrower than the statute.⁷⁴ The regulation would disallow deductions for (i) illegal bribes or kickbacks paid to an official or employee of a government other than a foreign government, and (ii) hypothetically illegal payments made to an official or employee of a foreign government. Thus the regulation does not cover either actually or hypothetically illegal payments to an agency or instrumentality of any government. Notice also that the regulation concerning this part of section 162(c)(1) does not declare lawfulness or unlawfulness under the laws of the foreign country to be irrelevant, as it does regarding the hypothetical illegality test.⁷⁵ The reason for this difference is not evident.

The first part of section 162(c)(1) treats illegal kickbacks to a government agency or instrumentality in the same way in which it treats illegal bribes to a government official or employee. The second part of section 162(c)(1), however, denies deductibility to hypothetically illegal payments made only to an official or employee, but not to an agency or instrumentality of a foreign government. Since Octopus's \$150,000 kickback was paid to the Ministry of Commerce, an agency of the Homosian government, and not to "an official or employee of a foreign government," the payment would be deductible even if it would be unlawful under the laws of the United States, were they applicable. The reason for this inconsistent treatment of hypothetically unlawful payments to individuals and government agencies is not apparent.⁷⁶

The Commissioner might attempt nonetheless to disallow the \$150,000 deduction by reviving the old public policy doctrine. Yet

73. Although the Foreign Corrupt Practices Act has yet to be interpreted, we believe that such a payment probably would be considered not to have been made with the "corrupt" intent required by the Act. See note 3 *supra*.

74. See note 26 *supra*.

75. Treas. Reg. § 1.162-18(a)(1)(i). S. REP. No. 85-1983, *supra* note 12, at 125, declares legality or illegality under foreign law to be irrelevant to the deductibility of payments to foreign government officials or employees, but this was before the language regarding kickbacks was added to § 162(c)(1).

76. A deduction for this payment could not be disallowed under § 162(c)(2) for the same reasons that the payment to the agent could not be denied deductibility. See pp. 1099-1100 *supra*.

even in its strongest form, the public policy doctrine would probably not reach this payment. A deduction was allowed under the old public policy doctrine where the kickback: (1) was not illegal; (2) did not relate to a transaction that constitutes unfair competition under the Federal Trade Commission Act; (3) was "ordinary" in the sense of being normal, usual, and customary in the community; (4) was appropriate and helpful in obtaining business; and (5) was paid to persons with whom the taxpayer was doing business or, if paid to an employee of such a person, was made with the knowledge of that person.⁷⁷

Under these criteria the only question for Octopus is whether its payment was "ordinary." The meaning of "ordinary" is illustrated by *Lilly v. Commissioner*.⁷⁸ In *Lilly* the taxpayer paid kickbacks to doctors who prescribed glasses made by the taxpayer. The kickbacks were found to be "ordinary" because they were the common practice in the community and "necessary" because they were required to meet competition. Assuming that Octopus's payment was part of a common practice and necessary to meet competition, then even under the old public policy doctrine it would be deductible.

Moreover, the policy considerations disfavoring bribes lend some support to the deductibility of this kickback. First, because the payment was made directly to the agency and was open and obviously traceable, the possibility of corruption is reduced and, in fact, is likely to have been small. Second, unfair competition in the normal sense does not occur because such payments are demanded equally from anyone awarded a contract and because that fact presumably is or will be known by bidders on such contracts (which makes the payment similar to a tax, albeit one assessed and collected by only one part of the government). Third, investments may be affected because the funds may be used for projects not selected by the government as a whole, but the deviation from the government's investment priorities will presumably be less severe than if the \$150,000 had gone to an individual for personal use. Nevertheless, that this kickback is less objectionable than the typical bribe is not conclusive in favor of deductibility, because the typical bribe is not deductible.

77. Rev. Rul. 58-479, 1958-2 C.B. 60; cf. *Pittsburgh Milk Co. v. Commissioner*, 26 T.C. 707 (1956) (violation of public policy made expense nondeductible but doctrine had no application in determining taxpayer's gross income; thus, money received by taxpayer and subsequently kicked back to purchaser could be treated as type of rebate that in effect reduced purchase price received by taxpayer). For the view of the Commissioner contrary to *Pittsburgh Milk*, see Rev. Rul. 62-194, 1962-2 C.B. 57. See also *United Draperies, Inc. v. Commissioner*, 41 T.C. 457, *aff'd*, 340 F.2d 936 (7th Cir. 1964), *cert. denied*, 382 U.S. 813 (1965).

78. 343 U.S. 90 (1952). See generally Schwartz, *Business Expenses Contrary to Public Policy: An Evaluation of the Lilly Case*, 8 TAX L. REV. 241 (1953).

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C. *The Extortion Payment*

The third payment—the \$200 gift to the harbormaster—appears to be an extortion payment even though the harbormaster did not explicitly demand the payment to expedite the unloading of Octopus's building materials. As with the bribe and the kickback, this payment does not appear to be unlawful under the Foreign Corrupt Practices Act,⁷⁹ and, in any event, the appropriate test is hypothetical illegality.

Cases decided under the domestic antibribery statute, 18 U.S.C. section 201(b), and the domestic antigratuity statute, 18 U.S.C. section 201(f), suggest that Octopus's payment to the harbormaster may not be deductible. The Second Circuit has held that extortion based on a threat of economic harm is not a complete defense under either statute, but is only evidence of a lack of the requisite intent to bribe and is irrelevant to the intent required to violate the antigratuity statute.⁸⁰ Under this standard, Octopus's payment to the harbormaster would not be deductible.

Octopus could make a substantial argument, however, that economic coercion by a government official should be treated as a complete defense under either statute for purposes of determining the deductibility of questionable foreign payments. The Second Circuit has explained that a threat of economic harm was not a complete defense to bribery because “[t]he proper response to coercion by corrupt public officials should be to go to the authorities, not to make the payoff.”⁸¹ Such a policy is less compelling with respect to payments made in a country where the law enforcement officials themselves may be receiving payments or where reporting coercion will itself result in the threatened harm. Also, whereas federal courts are under an obligation to encourage compliance with all federal statutes, including that prohibiting extortion,⁸² they are not under any obliga-

79. Although the Act has yet to be interpreted, we believe that such a payment was not made to “assist . . . in obtaining or retaining business for or with, or directing business to, any person.” Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, §§ 103(a), 104(a), 91 Stat. 1495-97 (to be codified at 15 U.S.C. §§ 78dd-1, 78dd-2). In addition, the harbormaster in the hypothetical may qualify as an official “whose duties are essentially ministerial or clerical.” *Id.* See note 3 *supra*.

80. *United States v. Barash*, 365 F.2d 395, 401-02 (2d Cir. 1966). The conclusion in *Barash* that proof of extortion is irrelevant to the antigratuity statute is open to serious question on two grounds. First, the *Barash* court arguably applied the wrong standard of intent in reaching its conclusion. See p. 1111 *supra*. Second, it seems highly unlikely that Congress intended, in enacting § 201(f), to make everyone who submits to economic coercion by a government official criminally liable.

81. *United States v. Kahn*, 472 F.2d 272, 278 (2d Cir.), *cert. denied*, 411 U.S. 982 (1973).

82. 18 U.S.C. § 1951 (1970). See B. Toms, *The Status of Extorted Payments under the Foreign Corrupt Practices Act of 1977* (Dec. 30, 1977) (unpublished manuscript on file with *Yale Law Journal*).

tion to encourage compliance with foreign antiextortion laws. Moreover, efforts by United States businesses to enforce foreign antiextortion statutes may harm both United States business interests and United States foreign policy, especially where high government officials are involved in extortion schemes. Finally, the recent enactment of the Foreign Corrupt Practices Act supports the treatment of extortion as a complete defense as far as questionable foreign payments are concerned. Foreign payments based on at least certain types of economic coercion (and perhaps all types of economic coercion) most probably are legal under the Act.⁸³ In explaining the decision not to prohibit certain foreign payments that were objectionable in the United States, the House Report stated:

While payments made to assure or to speed the proper performance of a foreign official's duties may be reprehensible in the United States, the committee recognizes that they are not necessarily so viewed elsewhere in the world and that it is not feasible for the United States to attempt unilaterally to eradicate all such payments. As a result, the committee has not attempted to reach such payments.⁸⁴

These same arguments apply to hypothetical illegality under the anti-gratuity statute, 18 U.S.C. section 201(f). A substantial argument exists, therefore, that extortion payments to foreign government officials would be deductible per se even if based on economic coercion. Under this standard, Octopus could probably deduct its \$200 payment.

The Commissioner may rely on much earlier cases that disallowed deductions for extortion payments. But the continuing authority of these decisions may be questioned because they predated the demise of the public policy doctrine and because extortion payments are not now explicitly disallowed by the Code.

Even assuming that these older cases have some current relevance, there is good reason to distinguish them from Octopus's situation. In *Bonney v. Commissioner*,⁸⁵ a taxpayer married a woman whose divorce decree had prohibited her from remarriage. The marriage was annulled, but the taxpayer's putative wife made derogatory accusations that the taxpayer feared would adversely affect his professional reputation. To solve his problem, the taxpayer gave money and property to

83. See note 3 *supra*. Although "grease" payments are not defined in the Act, they include many, and arguably all, extortion payments. See pp. 1117-18 *infra*.

84. H.R. REP. NO. 95-640, *supra* note 3, at 8; see S. REP. NO. 94-1031, *supra* note 15, at 6-7 (similar language).

85. 247 F.2d 237 (2d Cir.), *cert. denied*, 355 U.S. 906 (1957).

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his putative wife and claimed a deduction. The deduction was disallowed. *Bonney* is easily distinguishable because the payments were remotely connected with the taxpayer's business; that is, they were made to deal with a marital problem that affected the taxpayer's business only indirectly.

Two other cases involved payments directly connected with the taxpayer's business. In *Reliable Milk & Cream Co.*⁸⁶ amounts paid to racketeers under fear of beatings of milk dealers and burning of trucks were held not to be deductible. *Kelley-Dempsey & Co. v. Commissioner*⁸⁷ involved payments made to an employee of a company for which the taxpayer was laying pipelines. The payments were made to secure relief from arbitrary demands by the company's inspectors. The taxpayer's "work under its contracts was impeded through harassing tactics," but after "it 'greased some palms', its work was accepted."⁸⁸ The court held that the payments were not deductible.

In both *Reliable Milk* and *Kelley-Dempsey* the courts reasoned that the expenses were not "ordinary," because they did not proximately result from the ordinary conduct of business, and that the payments were not "necessary" even though they were the easiest way of dealing with the situation. The reasoning of the courts on this latter point was based on the fact that the taxpayer could have sought protection from the proper authorities rather than making the extortion payments.

The reasoning of these cases suggests that Octopus's extortion payment may deserve different tax treatment. First, what is considered "ordinary" in the United States may be very different from what is considered "ordinary" in other countries. Second, the payments in foreign countries may be "necessary" because there may be no alternative method of protection. If Octopus had not made its payment, unfortunate consequences could have followed, and there may or may not have existed authorities who could have or would have provided protection. There is, however, one aspect of the cases that have disallowed deductions that is applicable to Octopus's payment. By allowing deductions, such payments are made less burdensome to the payor and demands for such payments are encouraged.

In sum, these cases do not indicate that Octopus's extortion payment is nondeductible, because their authority has been swept away with the public policy doctrine and because they are distinguishable from Octopus's situation.

86. 7 B.T.A.M. (P-H) ¶ 38,290 (1938).

87. 31 B.T.A. 351 (1934).

88. *Id.* at 353-54.

III. The Problem of Conceptual Distinctions

Certain of Octopus's tax problems exist only because its payments fall on the borderlines of what are otherwise clear tests of deductibility. It would be fair to say, for example, that bribes generally are not deductible and that a substantial argument exists that extortion payments are deductible. If such a dichotomy in tax treatment does exist, then the distinction between a bribe and an extortion payment becomes crucial.

Octopus's \$100,000 payment to the agent was labeled a possible "bribe." If it was a bribe, and therefore hypothetically illegal under United States law, then it would not be deductible. But might Octopus contend that it was an extortion payment and thus possibly deductible?

The answer depends on a conceptual distinction between a "bribe" and an "extortion payment." This distinction might be drawn in two ways. First, bribes are usually initiated by the payor, whereas extortion payments are initiated by the payee. But many bribes may first be suggested by the payee. Moreover, this distinction turns on facts that are easily manipulated to gain favorable tax treatment, and it will typically be difficult for the Commissioner to refute a taxpayer's factual contentions.

A second way in which to distinguish bribes and extortion payments is that a bribe is a payment made to ensure that the payor will receive or retain something that would ordinarily not be forthcoming to him or ordinarily retained by him, whereas extortion payments are made to secure or retain something that is ordinarily forthcoming to the payor or ordinarily retained by him.⁸⁹ This difference between a bribe and an extortion payment should hold true regardless of who first suggested or initiated a payment.

To illustrate this distinction, consider the payments made in *Reliable Milk*.⁹⁰ The taxpayer made payments to racketeers for their promise not to beat up its dealers or burn its trucks. These were extortion payments because the taxpayer would ordinarily not have had its dealers beat up or trucks burned. Similarly, in *Bonney*⁹¹ the taxpayer made payments to his putative wife to induce her to stop making damaging statements. Even though the taxpayer in *Bonney* may well have been the first to suggest the *quid pro quo* of money for silence, the transac-

89. The Senate Committee on Banking, Housing, and Urban Affairs made the same distinction regarding possible criminal sanctions for corrupt overseas payments. S. REP. No. 95-114, *supra* note 3, at 11. For a discussion of extortion payments under the Foreign Corrupt Practices Act, see note 3 *supra*.

90. *Reliable Milk & Cream Co.*, 7 B.T.A.M. (P-H) ¶ 38,290 (1938).

91. *Bonney v. Commissioner*, 247 F.2d 237 (2d Cir.), *cert. denied*, 355 U.S. 906 (1957).

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tion involved an extortion payment and not a bribe because the taxpayer would ordinarily have been free from his putative wife's harassment.⁹²

Applying this distinction to Octopus's possible bribe, suppose the lowest bidder on a contract with Homos ordinarily wins the contract. If Octopus was not the lowest bidder and makes a payment to an Homosian official to win the contract, then the payment is a bribe. If instead Octopus is the lowest bidder and makes a payment to an Homosian official to ensure that it will win the contract, then the payment is an extortion payment.

This distinction makes most sense if the Homosian official went to Octopus before the contract was awarded and threatened to see to it that Octopus was not awarded the contract even though it was the lowest bidder. Suppose, however, there was no communication between Octopus and the Homosian official before the payment, that is, that there was no threat, express or implied, that the lowest bidder would not win the contract. Is the payment still an extortion payment and arguably deductible? Or, even if it is not an extortion payment, could one argue that it is not a bribe and thus, regardless of whatever other label one might attach to it, if it was ordinary and necessary for the taxpayer's business, then it should be deductible? Permitting such deductions would comport with the strong policy favoring the taxation of only net income, but it would also support and encourage ethically questionable business conduct. Payments intended to influence governmental decisionmaking are disfavored regardless of their actual effect,⁹³ because the mere fact that a bribe is paid has a tendency to corrupt (if for no other reason than that it may encourage extortion of further payments). Thus a deduction should be allowed only if the payment is based on a threat that the result predictable under the usual decision-making process would not be reached unless the payments were made,⁹⁴ or if the circumstances surrounding the payment make reasonable the payor's fear that such a result would not be reached.⁹⁵

Nondeductible bribes and deductible extortion payments might also

92. Where do kickbacks fit in the conceptual dichotomy? The terms "kickbacks" and "rebate" really describe the form of a payment. The distinction between a bribe and an extortion payment is one that is based on the substance of the payment. A kickback, therefore, could in substance be either a bribe or an extortion payment. Kickbacks that are bribes, then, ought not to be deductible and those that are extortion payments ought to be deductible.

93. See *United States v. Barash*, 412 F.2d 26 (2d Cir.), *cert. denied*, 396 U.S. 832 (1969).

94. Cf. *United States v. Hyde*, 448 F.2d 815, 833 (5th Cir. 1971), *cert. denied*, 404 U.S. 1058 (1972) (decided under antiextortion law, 18 U.S.C. § 1951 (1970)).

95. Cf. *United States v. DeMet*, 486 F.2d 816, 820 (7th Cir. 1973), *cert. denied*, 416 U.S. 969 (1974) (decided under antiextortion law, 18 U.S.C. § 1951 (1970)).

be distinguished by their size. The size of Octopus's \$100,000 payment to the agent suggests that it was not made to obtain a service or result that would ordinarily be forthcoming from the government. By contrast, the size of the \$200 payment to the harbor master suggests that it was nothing more than a "grease payment" to facilitate that which should ordinarily be forthcoming to the payor.⁹⁶

But the size of the payment has significance other than as an indicator of its nature. The policies that support nondeductibility for some foreign payments may vary in strength with the size of such payments. The strongest policy behind section 162(c) is the discouragement of morally improper business behavior. As we noted earlier, the moral reprehensibility of a payment is related to its tendency to corrupt, and the tendency of a payment to corrupt is related to its size.

Foreign policy considerations also support a distinction based on the size of a payment. The extent to which a payment may interfere with the proper conduct of a foreign government or lead to embarrassing publicity may well depend on the size of the payment. When millions of dollars find their way into the pockets of government officials or the coffers of a major political party, the potential for diplomatic havoc is significantly greater than when small payments are made, for example, to facilitate customs clearances.

Finally, larger payments generate greater unfairness in competition and potentially more acute deviation from governmental investment priorities. Discouraging small payments would also put American companies at a competitive disadvantage compared to multinational companies not subject to American tax laws. The same would be true, of course, for the discouragement of large foreign payments, but there the moral and foreign policy considerations become more important, and these considerations weigh heavily against deductions for large payments.

There is, of course, a factual issue in distinguishing between non-deductible bribes and deductible extortion payments. For example, when Octopus executives paid the harbor master \$200 to expedite unloading their cargo, they had already waited past the average waiting time of sixty days. If they would ordinarily have had their ship unloaded within sixty days, then their payment would look like an extortion payment. But the problem here is determining how Octopus would ordinarily have been treated. In many parts of the world, establishing just what would ordinarily be forthcoming will be nearly impossible.

96. The term "grease payments" is used by, *inter alia*, the Senate and House reports on prohibiting bribes of foreign governments. S. REP. No. 95-114, *supra* note 3, at 10; H.R. REP. No. 95-640, *supra* note 3, at 8.

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Similarly, it is difficult to judge the effect of the amount of a payment on its deductibility. If the impact of a particular amount is due to its reprehensibility or potential embarrassment to the United States, then a fixed dollar guideline for deductibility would not be sensible. The reprehensibility of a payment is relative to its object. For example, most people would probably agree that it is less reprehensible to give a headwaiter \$20 to get a better table than to give a teacher \$20 to boost a child's grade. Similarly, the potential of a payment to embarrass the United States varies from country to country with the cost of living and differences in what is morally acceptable.

In light of these considerations, payments of like amounts should be treated differently depending on whether they are more accurately classified as bribes or extortion payments. The alternative would be a presumption that all payments below a certain amount are deductible. Such an approach would be less costly from an administrative standpoint and would recognize that many small payments are not as dangerous as large payments of the same type. But it could also result in deductibility for small bribes (some of which could have a large effect on decisionmaking), in encouraging officials to demand bribes or other payments just below the cutoff line, and in restructuring otherwise unitary payments into series of payments, each of which is below the cutoff line. Given the current fabric of section 162(c) and its apparent policy objectives, a payment-by-payment approach is preferable.⁹⁷

IV. The Future of Section 162(c)

Section 162(c)(1) suffers from vagueness. An especially acute uncertainty concerns the level of intent necessary under the hypothetical illegality test, an uncertainty exacerbated because the regulations, in

97. The Securities and Exchange Commission, in an analogous situation, has not set a minimum cutoff level for "facilitating payments" (that is, payments made "to persuade low-level governmental officials to perform functions or services which they are obliged to perform as part of their governmental responsibilities, but which they may refuse or delay unless compensated," SEC Report, *supra* note 1, at 26-27) in determining whether payments are "material." Some such payments have been found to be material if they are large in amount either individually or in the aggregate, or if there exists other corporate management misbehavior in connection with those payments or with their accounting or reporting. *Id.* at 27.

The Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, 91 Stat. 1494, apparently exempts "grease payments" on three grounds—lack of corrupt motive, nature of the recipient's employment, and failure to involve assistance in "obtaining or retaining business for or with, or directing business to, any person." See note 3 *supra*. The first ground is similar to that which we propose. For difficulties associated with the second and third, see *id.*

what is probably an invalid extension of the Code, purport to apply an objective, after-the-fact test devoid of any requirement of intent. Section 162(c)(1) also suffers from its embodiment of several odd and unsupportable distinctions between, for example, payments illegal under United States law and those illegal under foreign law, and between hypothetically illegal payments made to an official or employee of a foreign government and those made to an agency or instrumentality of that government.

Section 162(c), however, need not remain in its current form, with all of its attendant difficulties. One of Congress's major concerns in enacting section 162(c) was its view that foreign bribes are morally wrong and ought to be discouraged. Foreign bribes were not then unlawful, and the Internal Revenue Code was used to encourage morality. Section 162(c) thus filled a vacuum in the criminal laws. But since the enactment of the Foreign Corrupt Practices Act, the need to use the tax laws to encourage morality is not as acute. Since certain foreign bribes are now unlawful, Congress should amend section 162(c) to eliminate the hypothetical illegality test.⁹⁸ That is, Congress should reshape section 162(c) to preclude deductions of payments—whether domestic or foreign—that are unlawful under United States law or generally enforced state laws. Other payments would be deductible if they are “ordinary and necessary.”⁹⁹

Such a change would obviate or at least reduce many of the practical and policy problems now caused by section 162(c). First, the difficulties of imputing intent under the hypothetical illegality test would be avoided altogether. Second, uncertainty about deductibility would be reduced, although it would not be eliminated. There may not be many prosecutions under the new Act, particularly in cases that would provide guidance for tax purposes. Witnesses and documents will sometimes be beyond the reach of judicial process. Foreign countries—especially those in which bribery or extortion is rampant—may not cooperate because of national sovereignty, internal political considerations, or the fact that the officials from whom cooperation is sought may be receiving payments subject to investigation by United States authorities. Not only may prosecutors be hamstrung,¹⁰⁰ but also the ability of some defendants to defend themselves may be so constrained as to constitute a denial of due process.¹⁰¹ If there are only a few

98. See pp. 1100-02 *supra*.

99. See note 23 *supra*.

100. See H.R. REP. No. 95-640, *supra* note 3, at 20 (minority views).

101. See Letter from Secretary of Commerce Richardson to Senator Proxmire, at 23, June 11, 1976 (on file with *Yale Law Journal*).

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prosecutions of the most egregious cases, the application of the Act will be uncertain. Thus significant uncertainty will probably remain a part of the tax laws in this area whether or not section 162(c) is amended. But the uncertainty will be less than it is now if section 162(c) is amended as suggested, because the Act (and probably the cases that will be prosecuted under it) provides a clearer definition of intent and a better basis for distinguishing between nondeductible bribes and deductible “grease” or extortion payments than do the present section 162(c) and its regulations.

A third benefit to be gained from amending section 162(c) as suggested is that its operation would be based primarily on a clear and updated statement of United States policy—the Act. The Act was based on extensive hearings and analyses directed at determining exactly how far the United States should proscribe questionable foreign payments. Factors such as the realities of international business, jurisdiction, enforcement, and diplomacy were explicitly considered.¹⁰² The role or weight of these and other factors may be different in tax law than in criminal law, but any differences are not large.

A fourth benefit of amending section 162(c) as suggested is that more questionable payments that are “ordinary and necessary” would be deductible than is now the case, due to the narrowness of the Act. This is consistent with the function of the income tax of taxing only net income.¹⁰³ The same narrowness, on the other hand, would reduce the impact of section 162(c) in discouraging immoral behavior if that concept is interpreted without reference to the Act. Discouraging immorality, however, is not the primary function of the tax system, and it conflicts in this instance with the fundamental goal of taxing net income.¹⁰⁴ Especially since the suggested amendment would continue to discourage precisely the behavior that Congress has made criminal, this consideration of discouraging immorality does not weigh strongly against the suggested amendment.

Similarly, the greater deductibility of questionable foreign payments that would result from the suggested amendment would reduce United States tax revenues.¹⁰⁵ The exact amount by which revenues would decrease is uncertain, but it is most unlikely that the reduction could

102. *E.g.*, H. CONF. REP. NO. 95-831, *supra* note 3, at 14; H.R. REP. NO. 95-640, *supra* note 3, at 8.

103. *E.g.*, *Commissioner v. Tellier*, 383 U.S. 687, 691 (1966).

104. S. REP. NO. 85-1983, *supra* note 12, at 125. *See also* STAFF OF THE JOINT COMMITTEE ON INTERNAL REVENUE TAXATION, STUDY ON INCOME TAX TREATMENT OF TREBLE DAMAGE PAYMENTS UNDER THE ANTITRUST LAWS 11-12 (Nov. 1, 1965).

105. Revenue receipts under I.R.C. §§ 952(a), 964(a), and 995(b)(1)(D) would also be affected, since they are dependent on the definition of § 162(c) payments.

be large enough to affect significantly the desirability of the suggested amendment to section 162(c).

On balance, then, section 162(c) should be amended to deny deductibility only to payments that are actually unlawful. Such an amendment would cure some problems of the current section 162(c) and alleviate others, at only a small cost.

Many of the shortcomings that an amended section 162(c) would have are due to shortcomings of the criminal law and, perhaps, to the inability of the United States and other nations to agree to appropriate treaties. The fact that the criminal laws are poorly designed or inadequate to deal with the immorality of foreign bribes does not justify badly written tax laws. The result has been and will continue to be a failure either to encourage morality in international business or to achieve a fair and workable tax system.

The Yale Law Journal

Volume 87, Number 6, May 1978

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